

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Fourth Quarter of 2000 to the Fourth Quarter of 2004

The current U.S. economic outlook is scaled back relative to the one that was presented in the January 2001 *Idaho Economic Forecast*. The most noteworthy change is that the economy is now expected to turn in a sub-par performance over the next few years. This can be seen by reviewing the projections for real GDP. In the previous forecast, real GDP was expected to grow by at least 3.6% per year through 2004. In the current forecast, this broad measure of the economy's health advances by less than 3.5% in both 2001 and 2002. In other words, the U.S. economy grows at below its potential during the first two years of the forecast. It should pick up steam after its slow start, but not enough to make up for lost ground. By 2004, real GDP is \$364 billion (3.3%) less than was previously forecast.

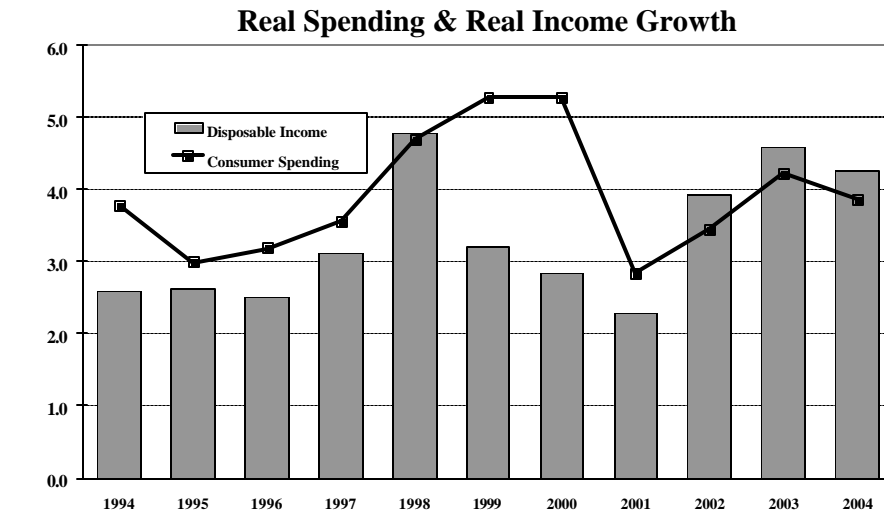
Other measures also testify to the economy's subdued performance. National nominal personal income goes from being 1.3% lower this year to 3.3% lower by 2004. In absolute terms, U.S. nominal personal income in 2004 is nearly \$350 billion lower than in the previous forecast. Adjusting U.S. personal income for the effects of inflation narrows the gap between the current and previous estimates. Specifically, U.S. real personal income is down 1.6% in 2001, 2.6% in 2002, 2.9% in 2003, and 2.8% in 2004. Under the current forecast, there is expected to be nearly 1.8 million fewer jobs in 2004 in the U.S. versus what had been anticipated earlier. The goods-producing sector takes its biggest hit in 2002, when its job numbers are down more than 400,000 from the previous estimate. It is down about 250,000 jobs in 2004. Service-producing employment is about 1.5 million lower in 2004.

Not everything about the forecast has changed, however. A key assumption in the previous and current forecasts is that the Federal Reserve negotiates an unprecedented second soft landing. The nation's central bank has successfully pulled off the first stage of this maneuver. It enacted a series of interest rate increases that helped cool off the economy. Now it needs to stimulate the economy before it crashes into a recession, but not so much as to cause it to overheat. The Federal Reserve loosened aggressively this winter when the economy showed signs of stalling. But because there is a six- to twelve-month lag between a monetary policy action and its impact on the economy, it remains to be seen whether the Federal Reserve has pulled off this difficult move. As mentioned above, this forecast assumes that it succeeds. As a result, the U.S. economy slows, but does not suffer a recession over the forecast period.

While the current forecast assumes the U.S. economy does not enter a recession, it cannot be ruled out completely. Indeed, the odds of a recession have been rising. This has been reflected in DRI's alternative forecasts of the U.S. economy. Two alternative forecasts of the U.S. economy have been prepared. Both contain recessions. The *Pessimistic Scenario* calls for an early recession. It has been assigned a 40% chance of occurrence. The *Late Recession Scenario* has an assigned probability of 10%. This implies a combined probability of occurrence of a recession to be 50%. This means that the odds are even for the economy entering into a recession. A detailed description of these two alternative forecasts, as well as their impacts on the Idaho economy, have been included in this publication.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: The direction of consumer spending will be a major determinant of the economy's near-term health. The biggest concern is the precipitous drop in consumer confidence. Two of the most respected measures of consumer confidence document this decline. As of winter 2001, the Conference Board index had declined for five straight months. The University of Michigan index had fallen for three months. Both surveys



recorded their biggest declines since 1990. In fact, there has never been a decline of this magnitude without a recession. Interestingly, the decline in confidence has not yet made a significant impact on spending. It is anticipated that real consumer spending actually accelerated to a 3.6% annual rate during the first quarter of 2001. Consumers are not confident, but they are spending as if they were. Several factors help to explain this paradox. First, though confidence is falling, it remains very high in absolute terms. Second, a detailed review of the confidence survey data reveals that households are more worried about the future than the present. Perhaps this explains why consumers expressed anxiety about the future, yet they have not hesitated to take on financial commitments. Counter to predictions of a weak year, light vehicle sales rose to a 17.6-million-unit annual pace in February, up from January's 17.1-million-unit pace. In comparison, 17.4 million light vehicles were sold during 2000's strong showing. The housing market, helped by falling interest rates, has also shown resilience to falling confidence. Third, there is a lag between confidence and spending. This lag is approximately six to twelve months, and suggests the major impact of falling consumer confidence on consumer spending will not be seen until this spring and summer. Coincidentally, consumer confidence could be shaken further during that period as layoffs announced last winter begin to take place. These layoffs will limit disposable income growth. Spending will also miss the infusion of money from other sources thanks to the current stock market correction. It is difficult to get a solid figure on how much stock market wealth gains have increased income. DRI estimates that 15% of federal tax revenue is coming from the stock market—through 401k withdrawals, capital gains, and stock option exercise. Keep in mind that this estimate probably underestimates this portion because it is based on U.S. Treasury data from three years ago. DRI also estimates that consumers spend about 2.5 cents for every dollar of wealth. Thus, the recent stock market correction has dampened the outlook for consumption (and tax collections). Absent this additional stimulus, real spending should grow about as fast as real disposable income. Specifically, real consumer spending is forecast to advance 2.8% this year, 3.4% next year, 4.2% in 2003, and 3.9% in 2004.

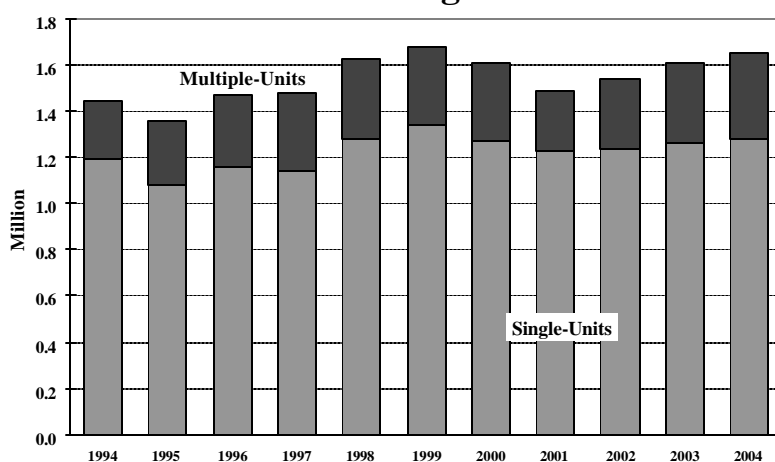
Financial: The Federal Reserve has remained true to its mission of promoting reasonable growth and controlling inflation. The nation's central bank took quick action earlier year this year when the economy showed signs of stalling. On January 3, 2001, it lowered its federal funds interest rate target by 50 basis points to 6.0%. It followed this move with another 50-basis point reduction to the federal funds target to 5.5% on January 31, 2001. It dropped this target another 50 basis points on March 20, 2001. To some this last move was disappointing. The stock market was in turmoil in March. Financial markets hoped for a steeper cut in March. However, the Federal Reserve surprised almost everyone by

reducing the federal funds rate another 50 basis points to 4.5% on April 18. The Federal Reserve appears to be taking a gradual approach. This approach reflects a lesson learned from the 1987 stock market correction. After that correction, the Federal Reserve attempted to speed up the pace of its policy adjustment. This created a “whipsaw” effect where interest rate declines were quickly followed by interest rate increases. This over stimulated the economy initially, but eventually led to the 1990-91 recession. The Federal Reserve should not repeat that mistake over the forecast horizon. It is expected to take small policy steps over the next few years. In the near term, it appears that the Federal Reserve will continue to cut until it is convinced the economy is on the mend. It should be pointed out, the Federal Reserve’s job has never been simple, and will become more complicated in the near future with the likely enactment of federal tax relief. Until recently, huge federal budget deficits limited federal fiscal policy options. Thus, the central bank did not have to consider major fiscal policies. On the other hand, inflation should remain tame, and this will afford the Federal Reserve a bit more room to maneuver.

Housing: Falling interest rates appear to have insulated the U.S. housing industry from the full sting of falling consumer confidence. In January 2001, mortgage rates actually dropped below 7.0%, their lowest levels in nearly two years. In response, the number of new housing permits increased and home sales increased. Sales of existing single-family homes, which account for 85% of the single-family market, was a seasonally-adjusted annual rate of 5.1 million units, which was up slightly from December’s 4.9 million-unit pace.

Interestingly, the West was the only region to experience a decline, which some experts attribute to the fallout of the dot-com crash. The housing sector’s surprisingly strong performance does not mean it is immune from a downturn. Consumer confidence remains the most important concern for the future performance of the housing market. Housing data reflect the economic conditions at the time sales agreements are reached, which is typically weeks before there is any exchange of funds. As a consequence, housing data lag other economic indicators. This suggests the effect of the recent decline in consumer confidence has yet to show up in the housing data. The first signs of these impacts are not expected to surface until the middle of this year. Favorable mortgage interest rates will partially offset the effect of falling confidence. U.S. housing starts should experience a U-shaped decline and recovery. Total starts are expected to drop to 1.48 million units this year, which is 7.5% lower than last year. Fears about the short-term performance of the U.S. economy will keep residential construction activity mostly flat for most of this year. As the economy picks up steam, residential construction growth should accelerate. This forecast reports U.S. housing starts of 1.48 million units in 2001, 1.54 million units in 2002, 1.61 million units in 2003, and 1.65 million units in 2004.

U.S. Housing Starts

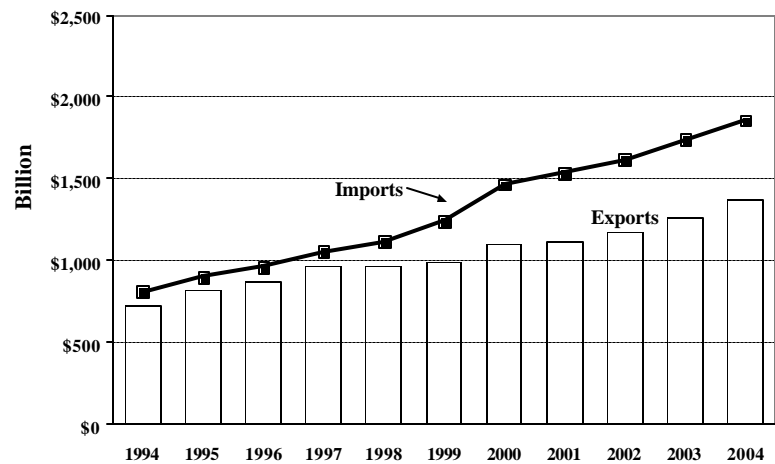


Source: Standard and Poor's DRI

International: The U.S. economic slowdown has impacts beyond its borders. Over the past few years, the U.S. has been the world's economic engine, growing the fastest among the world's largest economies. In 2000, U.S. real GDP grew by an impressive 5.0%. Japan, the world's second largest economy, eked out just 1.7% growth. France, Germany, Italy, and the United Kingdom's economies combined rose 3.1%. Canada's real output increased 4.9%. Some of the world's smaller economies enjoyed above average growth last year. For example, Mexico's real GDP increased 7.1%.

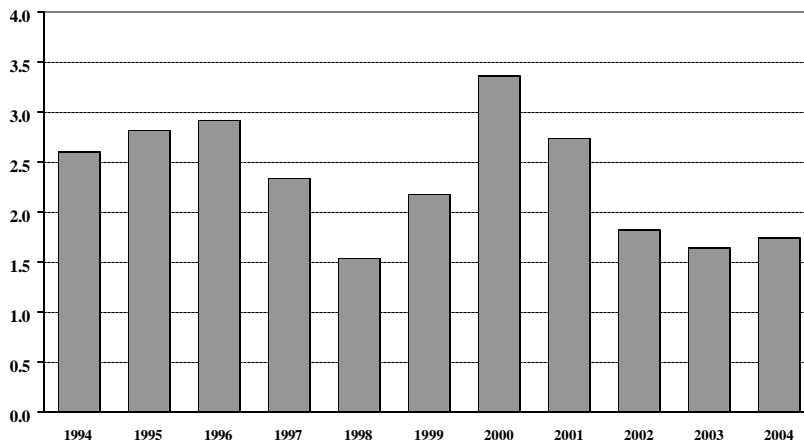
Proof of the U.S. economy's important role in stimulating the global economy is that imports have soared relative to exports. For example, real imports advanced 10.7% in 1999 and 13.6% in 2000. In comparison, real exports rose 2.9% in 1999 and 9.1% in 2000. As a result of this lopsided trade situation, the U.S. goods and services trade deficit swelled to nearly \$470 billion last year. Record deficits were also set with all major trading partners—Japan, China, Mexico, Canada, and Germany. China overtook Japan as the country with the largest trade gap. As the American economy cools, its appetite for imports should wane. This year, real U.S. GDP is anticipated to rise just 1.7%, which is well below the 3.0% expected for the whole world. Real imports should advance just 5.0%. This will create a challenge for those economies that have hitched a ride on the U.S. economic locomotive. Unfortunately, there is no other economy that can replace the horsepower of the U.S. economy. Western Europe should grow by 2.9% in 2001. However, most of its trade is intra-regional, and will be of little benefit to the rest of the world. Japan's economy is forecast to remain in the doldrums. Not all economies will suffer in the near future. The former Soviet Union and the Middle Eastern countries should hold up well this year. The primary reason for this is the lagged effect of oil-revenue windfalls on the economies of major oil-exporting countries. Real imports into the U.S. are expected to grow just 5.0% in 2001, 6.7% in 2002, 7.7% in 2003, and 7.0% in 2004. Real exports from the U.S. are projected to rise 1.9% in 2001, 5.4% in 2002, 8.5% in 2003, and 8.6% in 2004.

U.S. Imports and Exports



Source: Standard & Poor's DRI

Consumer Price Inflation



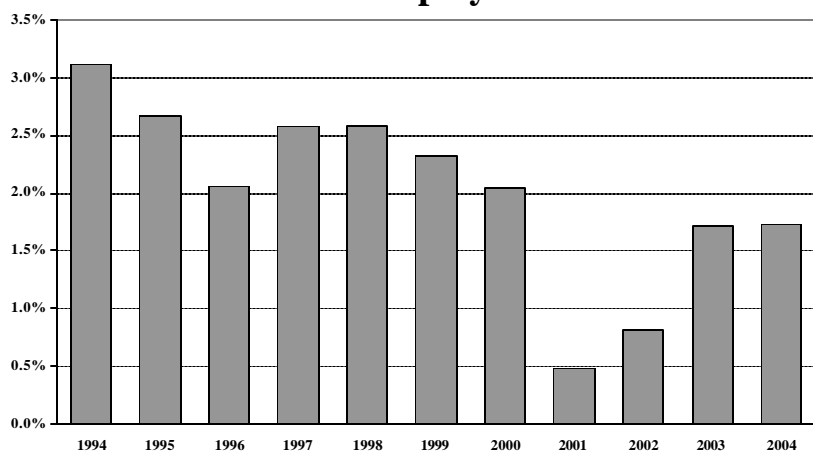
Source: Standard and Poor's DRI

Inflation: Despite spikes in producer and consumer prices in January 2001, the outlook for inflation remains benign. Producer-level inflation jumped due to higher prices for tobacco products, new cars, and paper products. A look at several factors suggests January's spike was temporary and inflation will be better behaved in the near future. For example, the energy price spikes that contributed to January's increase have eased. Spot natural gas prices were down 40% in early February from their mid-January highs. Of course, energy prices remain a wild card that

could have significant impacts on the economy. While energy prices are expected to ease over the next few years, they could prove to be volatile in the near term. OPEC appears primed to trim oil production for the second time this year. This will push oil prices back up in this year's second quarter, at the same time that markets head into seasonally strong demand. Depending on how electricity markets behave, natural gas prices could surge in the second and third quarters if hydroelectric production is short. High electricity prices could thwart several industries. One example is aluminum. High electricity costs have already idled more than 20% of U.S. smelting capacity. With such a large portion of capacity off-line, aluminum prices could rise rapidly once consumption rebounds. Chemical prices should be weak as manufacturers bring on additional capacity while consumption growth is sluggish. Supply and demand in the paper industry is not suffering from gross imbalances, so it should fare relatively well during the slowdown. This is not the case for steel. The combination of ample global capacity and high inventories suggests manufacturers will have a hard time making announced price hikes stick. At the producer level, prices for finished goods are forecast to rise 1.6% in 2001, 0.0% in 2002, 0.4% in 2003, and 0.7% in 2004. Consumer price inflation is expected to slow, but is higher than at the producer level. This is because consumer inflation is weighted more heavily to services costs, which are driven in large part by employment costs (wages and benefits). While employment cost growth should taper off from 2000's 4.5% rate, they should remain in the neighborhood of about 4.0%. Over the forecast period, inflation should be kept in check by retreating energy prices and well-behaved food prices. As a result, consumer prices are projected to rise 2.7% this year, 1.8% next year, 1.6% in 2003, and 1.8% in 2004.

Employment: While the economy remained above full employment this winter and spring, there is evidence it has weakened. For example, although the unemployment rate was 4.3% in March 2001, this was up 0.3 of a percentage point from last fall's 3.9% trough. Job gains have also slowed. Last year there was a net gain of around 250,000 jobs per month. This year the pace has slowed to about 100,000 jobs per month. In March 2001, there was a net loss of 85,000. Hardest hit has been the manufacturing sector that

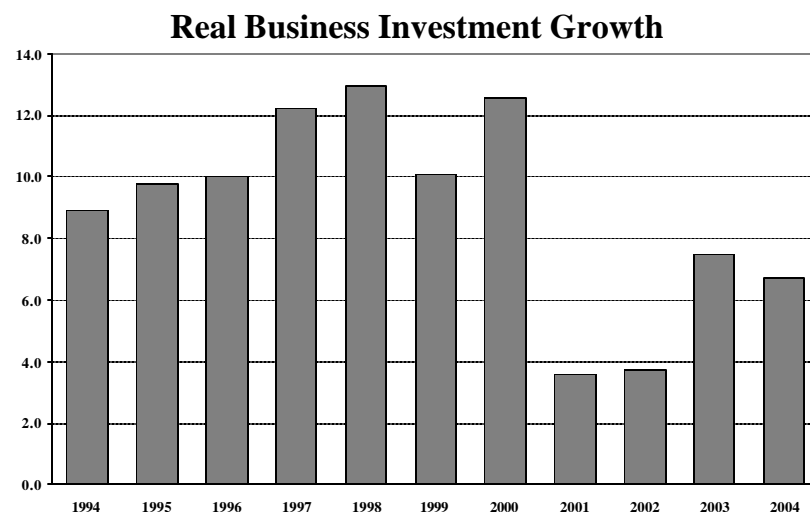
U.S. Nonfarm Employment Growth



Source: Standard and Poor's DRI

many experts believe is suffering recession-like conditions. There are fewer manufacturing jobs compared to last year. But this sector's calamities go beyond job losses. The factory workers that remain have noticed smaller paychecks because of shrinking overtime hours. The drop in factory hours and employment dragged down both the average economy-wide workweek and the index of aggregate hours. Another challenge facing the economy is the acceleration of wage gains. Wage gains increased an average of 3.7% through most of 1999 and 2000, but jumped to 4.0% recently. However, the softening labor market should slow these increases in 2001. Benefit costs are another concern because of rising health-care inflation. Employers have begun shifting these costs back to employees through higher copayments or by holding down wage increases. In this way, benefit-cost increases limit the expected deceleration of employee compensation even as labor markets slacken. U.S. nonfarm employment growth is anticipated to slow noticeably over the next couple of years before picking up speed in the latter years of the forecast. Specifically, nonfarm employment should increase 0.5% this year, 0.8% next year, 1.7% in 2003, and 1.7% in 2004. Not surprisingly, the unemployment rate is projected to rise to 4.9% in 2001, 5.3% in 2002, before easing to 4.9% in 2003, and to 4.7% in 2004.

Business Investment: Business investment is the one clearly weak spot of the economy. Consumer spending has remained healthy despite declining confidence. This has not been the case for the nation's business sector. For example, in the fourth quarter of 2000, business equipment spending declined for the first time since the first quarter of 1991. This reduction was due to the 37.5% annualized decline in light vehicle purchases. To put this in perspective, as recently as 1999, the real investment in light vehicles advanced by 12.2%. Another factor



Source: Standard and Poor's DRI

in real investment's fourth quarter showing was slowing computer sales. This is usually the fastest growing component of real investment, typically displaying double-digit growth. In the third quarter of 2000, it rose at a 41.6% annual rate. However, by the next quarter growth had slowed to just 8.6%. In recent years, equipment investment has been strong due to the combination of a tight labor market and low interest rates. Managers have been forced to substitute machinery for increasingly rare skilled labor. This helped real investment growth average 9.8% per year from 1991 to 2000. But with orders declining, the need to expand capacity has disappeared. Capacity utilization rates are falling, and even though the incentive still exists to cut labor, that can now be accomplished without adding machinery. The demand for computer and communications gears has slumped with the implosion of the dot-coms, as well as a lack of new software and operating systems requiring more powerful computers. Given these conditions, real investment in computers should slow over the forecast period. For example, this measure rose 40.0% in 2000, but is anticipated to grow just 19.2% in 2001. Not surprisingly, this will be a drag on overall investment. After increasing 12.6% in 2000, real investment spending is forecast to rise just 3.6% in 2001, 3.8% in 2002, 7.5% in 2003, and 6.7% in 2004. Looked at another way, real business investment should average 5.4% per year from 2000 to 2004, which is about half as fast as it grew in the 1990s.

Federal Budget: Tax revenues are still pouring into federal coffers. Through January 2001, individual receipts were up 9.0% from the previous year and corporate receipts were 12%. Meanwhile, federal government outlays increased just 2.5%, leaving a year-to-date surplus of \$74 million, which was up from \$42 million during the same period last year. It is anticipated that the federal budget surplus will swell to \$265 billion in this federal fiscal year. While this is welcome news, it is not without concern. Part of this surplus reflects capital gains from the stock market's high-tech bubble. While a precise estimate of this impact will not be known for several years, it is known that the proceeds from capital gains will be missing in future years thanks to the collapse of the dot-coms. The size of the surplus should shrink beginning fiscal year 2002 assuming a tax package is enacted and federal spending increases. The president's proposed \$1.6 trillion tax cut appears manageable. However, there are concerns that a much revised, and more expensive, tax relief package may emerge from Congress. Another concern is that Congress will not be able to hold the line on spending. Congress does not have a good record of leaving money on the table, and the huge surplus piling up may prove too tempting. The federal surplus (unified budget basis) is expected to shrink from \$265 billion in fiscal year 2001 to \$110 billion in fiscal year 2004.